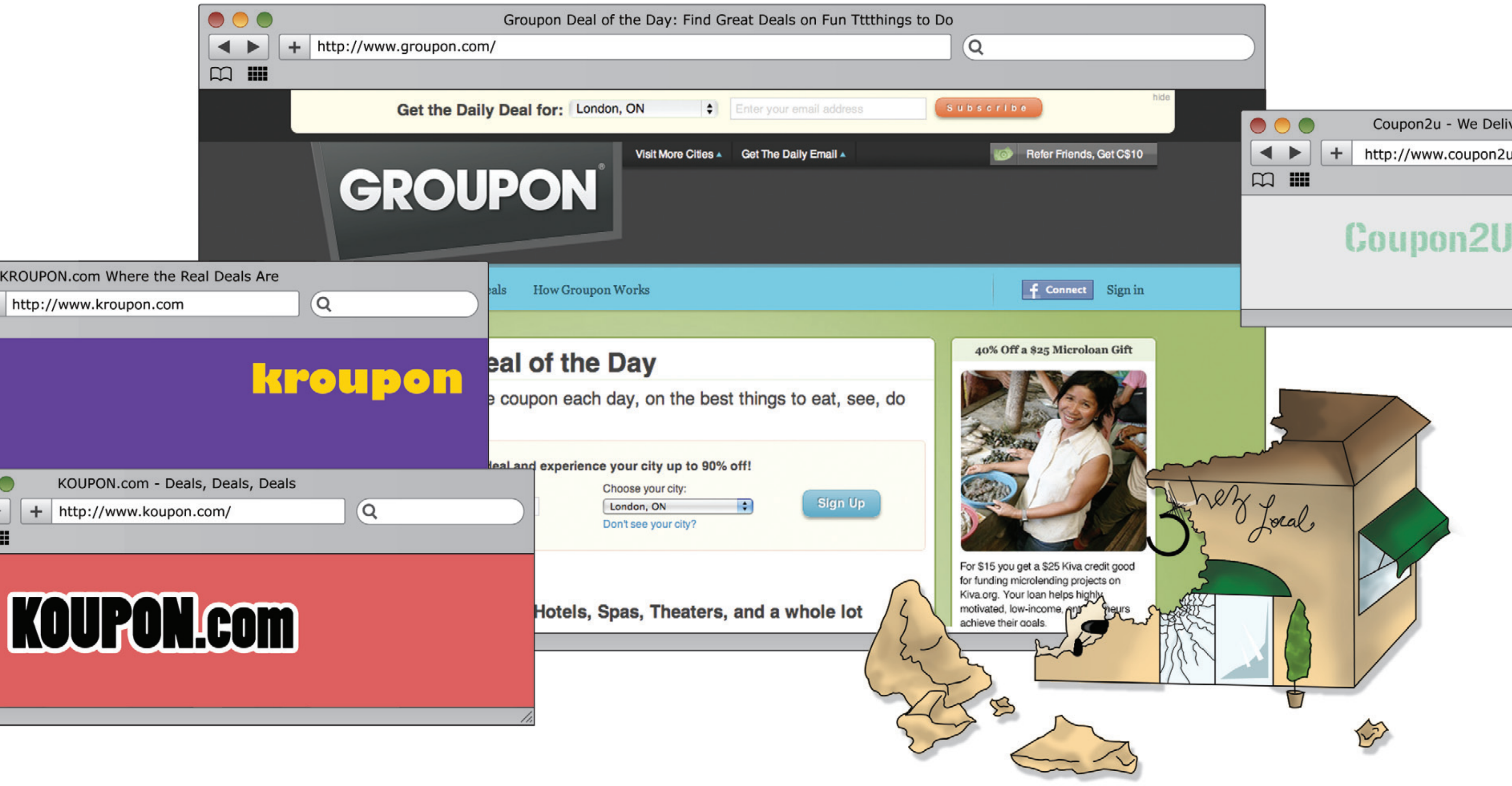


Groupoff

Should the fastest-growing internet company stick it out or take the money and run?

Written by Malini Jhaver and Stacey Yue

At $3 billion, you'd pay...

- $10,000,000 per city
- $1,000,000 per employee
- $214 per customer
- 6 times 2010E sales

It took Apple eight years to reach $1 billion (U.S.) in sales. Yahoo took six years, while Amazon and Google both took five. But the fastest-growing company in web history is on pace to hit the billion dollar sales mark in just over two years - a remarkable feat for a company of less than 3,000 employees. Meet Groupon.

Every day, Groupon emails a steep discount of 50% - 90% for a product or service to its 14 million subscribers, featuring a local deal in each of its 300 cities across 29 countries. Groupon partners with local businesses in each of its markets, from Copenhagen to New York City, to offer discounts on items ranging from meals to yoga classes. These high-value deals are exclusive to Groupon subscribers, meaning they are never offered through any other channels. To capitalize on these opportunities, subscribers have 24 hours to purchase the deal online, at which point they receive a voucher for the vendor's offer.

For example, a voucher worth $140 at a local spa would be featured on Groupon as a daily deal, selling for only $70. In purchasing the deal, the subscriber receives a 50% discount, paying $70 for a voucher equivalent to $140 in services. Groupon generates revenue by keeping a hefty 50% cut of the sales; for every voucher sold, Groupon pockets $35, while the spa retains $35. With businesses providing products or services worth more than four times the value of the revenue they receive, one wonders what the incentive is for vendors to partner with Groupon.

Making sense of the Groupon phenomenon

By offering such enticing deals through this novel channel, the spa hopes to gain new customers from its exposure amongst Groupon's large subscriber base. Groupon's subscribers also win, as they receive an exclusive deal. The Chicago-based company may be the biggest winner of all, raking in a generous commission that contributes to its projected 2010E revenues of $500 million. Groupon's market-leader status in the flash sales industry – time-limited email discounts offered exclusively to subscribers – suggests that its business aligns well with shifting social trends at the opportune time. The business model incorporates social networking as the cornerstone of its purchase process, whereby subscribers recommend membership and specific deals to friends.

The company's CEO, Andrew Mason, believes that Groupon has yet to exhaust its growth potential. Still a privately held company, Groupon has appeared on investors' radar, as evidenced by the $135 million (U.S.) it raised in an April financing round from Digital Sky Technologies. The level of interest shown by this Russian venture capital firm, renowned for financing internet giants such as Facebook and Zynga, might be indicative of Groupon's potential. Google seems to agree, as it reportedly showed interest in acquiring Groupon for a price upward of $3 billion (U.S.). With plans to continue geographic expansion and increase the number of vendor partners, Groupon will require significant financing to execute on its lofty goals. This leaves Mason and his team to decide where the money will come from: should Groupon accept Google's acquisition offer and sell out, or remain independent in the flash sales game and raise another round of financing itself? The answer to this question lies in understanding the company's value.

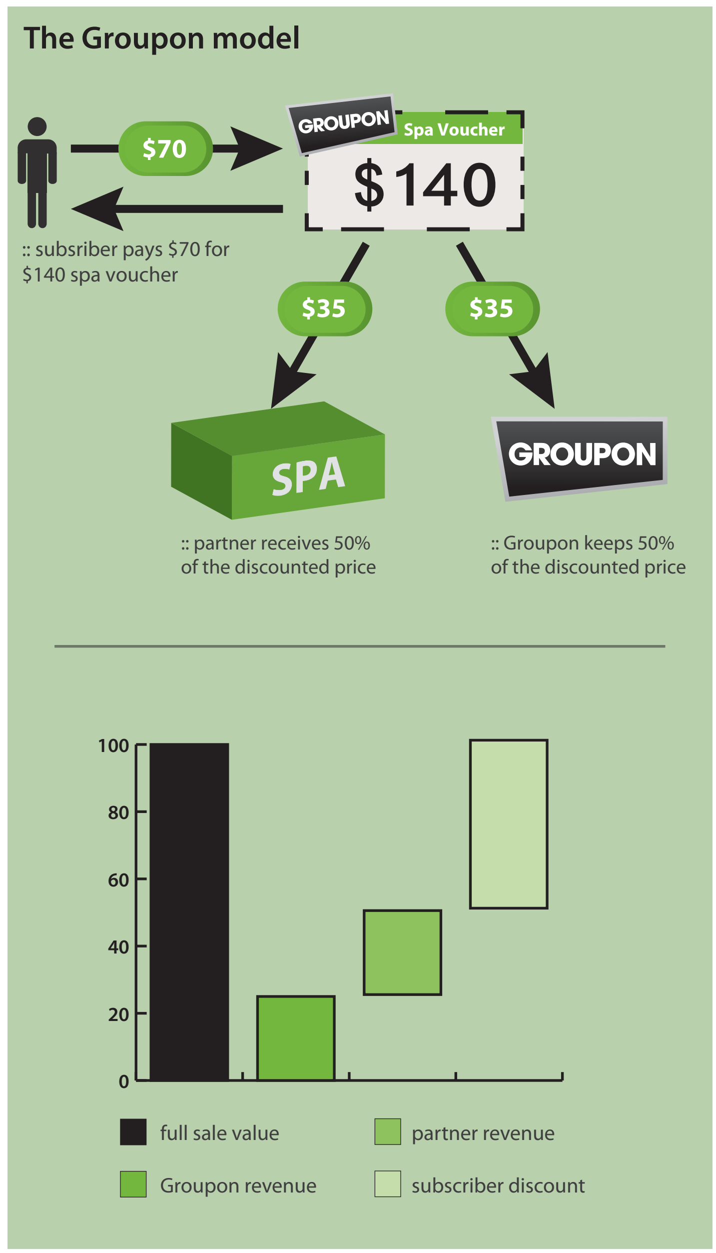
Where does Groupon's value lie?

In an industry marked by low barriers to entry, Groupon's market leadership and expertise form a tenuous competitive advantage. New entrants can easily mimic Groupon's deal-a-day model, as seen by the hundreds of imitators worldwide. Large players with the brand recognition and financial backing to challenge Groupon are launching their own flash sales initiatives, such as Amazon, AOL and Facebook. As competition intensifies in this market, Groupon's leadership position will likely erode.

Unable to defend against new entrants, Groupon may rely on its subscribers as the source of its value. The company boasts the largest subscriber base, currently at 14 million, easily ahead of rival LivingSocial in second place at 10 million. Despite this gap, Groupon's four million subscriber cushion does not provide a sustainable advantage. As competitors raise funds to grow and acquire niche deal-a-day sites, their subscriber base also rises rapidly to erode Groupon's market leadership. In this scenario, the value of the Groupon brand would be diminished, leaving the company with little bargaining power among its vendor partners. Given that Groupon's current subscriber advantage is slowly slipping away, its value as an acquisition target may not remain high for very long.

While it may be easy for competitors to enter the flash sales industry due to low barriers to entry and high perceived value in subscriber numbers, Groupon may still possess an overlooked weapon. As the dominant player, a large part of Groupon's credibility is derived from its vendor partners. In fact, vendor demand for Groupon partnerships is so strong that the company can afford to be selective, turning down seven small businesses for every one that it features. In addition, 95% of past vendors claim they would participate again. This demand suggests that Groupon's true value does not lie in its industry, subscriber base or brand, but rather in the existing vendor relationships.

Considering the $3 billion (U.S.) offer, one must question how much Groupon's valuable vendor relationships and established sales efforts are truly worth. For this price, Google would be paying approximately $214 (U.S.) per subscriber or $10 million (U.S.) per city to secure Groupon's relationships and presence. Given that these relationships are with small local businesses, it seems absurd to believe that Google could not enter the flash sales market itself for less, especially when considering the recognition



and reach of Google's brand. Google could easily leverage its existing sales relationships with small business search and map clients to challenge Groupon, for much less than $3 billion (U.S.). Perhaps Google is willing to overpay simply to ensure it does not lose out to another bidder, such as Yahoo!, who was proposing an acquisition only weeks before Google's offer. Moreover, Google may recognize Groupon as a way to decrease its reliance on search advertising revenue by expanding Groupon's reach to its own 177 million Gmail users. Regardless of Google's agenda, Groupon should consider this offer very seriously by weighing the terms against its internal assessment of its future, standalone prospects.

Reality check

Realizing that its true value lies in its vendor relationships, Groupon's decision to sell or stay the course must consider how it will retain its small business partners. Competitors may soon present more compelling offers, including lower commission rates to benefit vendors or even targeted deals specified to consumers' interests. Groupon typically commands a 50% cut of voucher sales, while competitors such as LivingSocial take only 30%. This undercutting of Groupon's price may threaten the company's advantage in its vendor relationships, as competitors offer small businesses better value.

Competition is not the only challenge Groupon must be cognizant of going forward. Vendors may also begin to lose interest in Groupon as they realize the deal-a-day service is not necessarily suitable for their business. Launching a Groupon offer may in fact be disastrous for a small business when one considers Groupon's hefty cut and the potentially massive flood of customers. While some small businesses may be willing to take a loss to gain new customers, others are unable to handle such volume. Groupon has inadvertently created a new problem for its small business partners: what happens when you have *too much* demand?

Recently, a Boston helicopter city tour operator partnered with Groupon, only to receive an overwhelming number of purchases; it had expected to sell 200 - 500 vouchers, but had to beg Groupon to shut down the deal by 11:00 a.m. after selling 2,600 vouchers. To accommodate the unanticipated influx of customers seeking to redeem this voucher, the helicopter company has had to honour its obligation at the discounted ticket price, severely compromising on margins. As the risks of partnering with Groupon are publicized, the Groupon bubble may slowly begin to deflate.

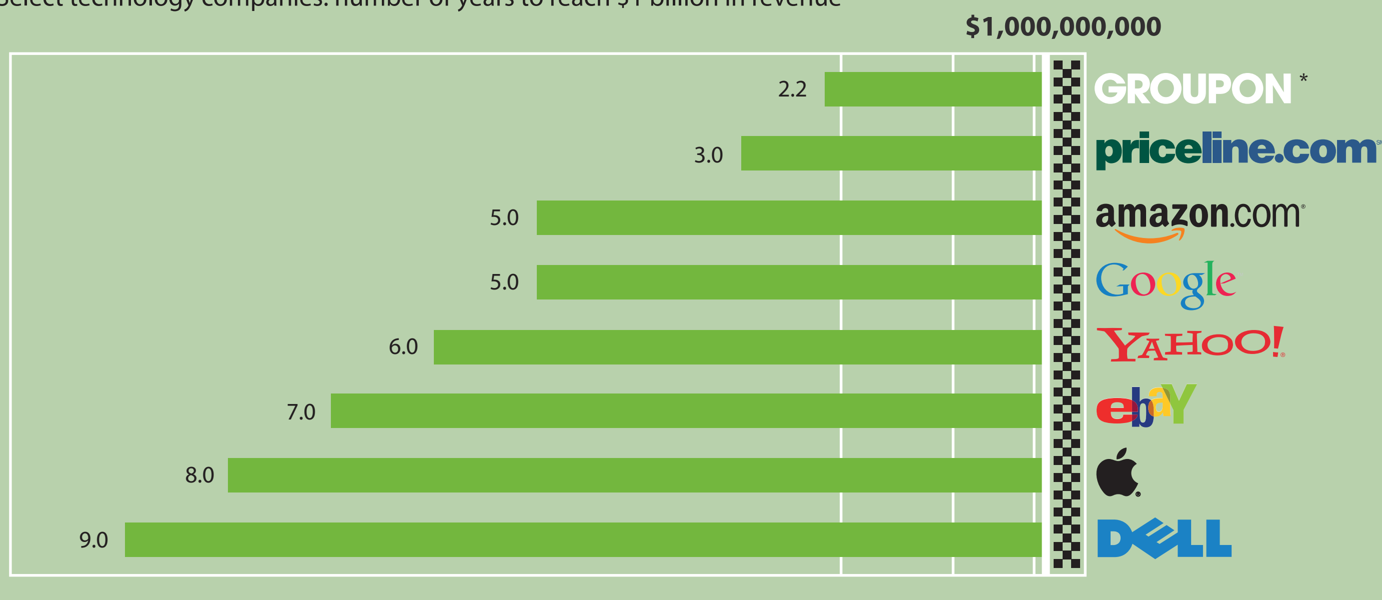
One must also question how valuable Groupon consumers are to a small business. Partnering businesses seek exposure with the ultimate goal of converting trial consumers into repeat customers. However, these buyers are typically bargain-hunters, who would likely never purchase a business' product or service without the Groupon offer. These individuals are thus more likely to wait for the next voucher for a similar product than to become a repeat customer. As vendors fail to realize their goal of developing repeat business, they may reconsider their support for Groupon.

Groupon's market-leading position suddenly appears far more precarious based on these threats to its business model. The company should sell before these flaws become apparent; otherwise, it will be too late to exit the game. The question, however, is whether this two year-old is ready to sell.

It may be more a matter of opportunity than of readiness. Groupon must understand the length of its selling window - the earlier it can sell, the better. Its current hype and level of success are not sustainable. Akin to what happened during the tech bubble of the late 1990s, analysts are applauding Groupon for all the wrong reasons. They overlook future prospects in the myopia of the company's newsworthy growth story. Remembering that the tech bubble also seemed invincible at one point in time, Groupon may well be the bubble of today - a newborn company destined to crash. The time to sell is now, while the company is in the spotlight and Google's or another investor's ears are open. It is only a matter of time before the Groupon bubble bursts, leaving the company with a clear answer: take the money and run.

Race to a billion

Select technology companies: number of years to reach $1 billion in revenue



* Based on projected data